No. 15-145

IN THE

Supreme Court of the United States

HUSKY INTERNATIONAL ELECTRONICS, INC.
Petitioner,

v.

DANIEL LEE RITZ, JR.
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF OF *AMICUS CURIAE* THE NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS IN SUPPORT OF THE RESPONDENT, DANIEL LEE RITZ, JR.

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INTEREST OF THE *AMICUS CURIAE*[1]

Incorporated in 1992, the National Association of Consumer Bankruptcy Attorneys ("NACBA") is a non-profit organization with a membership of more than 3,000 consumer bankruptcy attorneys nationwide. NACBA's mission includes educating the bankruptcy bar and the community at large on the uses and misuses of the consumer bankruptcy process. Additionally, NACBA advocates nationally on issues that cannot adequately be addressed by individual member attorneys. It is the only national association of attorneys organized for the specific purpose of protecting the rights of consumer bankruptcy debtors. NACBA has filed *amicus curiae* briefs in various courts on behalf of consumer bankruptcy debtors. *See, e.g.*, *Lamie v. U.S. Trustee*, 124 S.Ct. 1023 (2004)(discussing § 330); *Hamilton v. Lanning*, 130 S. Ct. 2464 (2010); *United Student Aid Funds v. Espinosa*, 130 S. Ct. 1367 (2010); *Mort-Ranta v. Gorman*, 721 F.3d 241 (4th Cir. 2013); *Weber v. SEFCU*, 719 F.3d 72 (2d Cir. 2013).

Amicus urges the Court to affirm the decision of the Fifth Circuit, and thereby to retain the existing principle that debt does not become non-dischargeable under 11 U.S.C. § 523(a)(2)(A), unless the objecting creditor can establish that the debtor made a "misrepresentation" that induced the creditor to enter into the credit transaction. Petitioner urges a change in the law that would eliminate this requirement, and

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[1] Letters of consent have been filed with the Clerk. Pursuant to Supreme Court Rule 37.6, *amicus curiae* state that no counsel for a party has authored this brief in whole or in part, and no person or entity, other than *amicus curiae* or their counsel, made a monetary contribution to the preparation or submission of this brief.

deny a discharge to individuals who, sometimes years later, are alleged to have participated in a fraudulent transfer. We write to address this issue of transferee liability.

The impact from reversal of the Fifth Circuit decision will be felt mostly by honest Chapter 7 debtors, those who are entrepreneurs and owners of small and medium sized businesses that faced distress. The size of this group is significant. "One in seven individuals in the bankruptcy system is a struggling entrepreneur."[2] The Chapter 7 debtor who was or is "self-employed, tends to be "distinct financially from other bankruptcy debtors."[3] It is this group of honest debtors for whom loss of a discharge based on alleged transfers is particularly harmful. This is because transfers that may become labelled as "constructively fraudulent" under the Code are the same transfers that are the daily stuff of a small to medium sized businesses. The ability to deny an individual debtor a discharge based on transferee "fraud" will become a potent weapon that is likely to

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[2] Robert M. Lawless and Elizabeth Warren, *The Myth of the Disappearing Business Bankruptcy*, 93 CAL. L. REV. 743, 786 (2005). "And yet about one in seven bankrupt filers . is someone trying to cope with the collapse of a small business."

[3] Robert M. Lawless, *Striking Out on their Own: The Self Employed in Bankruptcy, in* BROKE: HOW DEBT BANKRUPTS THE MIDDLE CLASS, (Katherine Porter ed, 2012) p. 103. Professor Lawless has made an extensive study of the "self-employed," and how they fare in bankruptcy. He defines "self-employed" as including those who are the sole or primary owner of a corporation or other entity, as well as "sole proprietors" of a business. His research discloses that 36.5 percent of self-employed in bankruptcy operated as corporations, limited partnerships, limited liability companies, or similar entity . " *Id.* at 109.

be fiercely used against the owners of small and medium businesses, and will distort both the letter and policy of the Code. Creditors in the position of Husky International already have ample protection under § 523(a)(6), and have no need for the outcome sought by Petitioner.

SUMMARY OF THE ARGUMENT

The issue before this Court is not merely whether an individual debtor will lose a portion of his or her discharge under § 523(a)(2)(A) even in the absence of making a misrepresentation to a creditor in order to obtain money or property. The issue is much broader and far more consequential to individual debtors engaged in small and mid-sized business. Instead, Petitioner seeks to enlarge the non-discharge provisions of § 523(a)(2)(A) to now include a transferee of a fraudulent conveyance, (Pet. Br. 14) even in the absence of justifiable reliance and a misrepresentation made to the creditor, and even where the original debt was not "obtained by fraud."

This Court ruled over 140 years ago, that a transferee of a constructively fraudulent conveyance *does not lose* his or her discharge because of their involvement in the transfer. *Neal v. Clark*, 95 U.S. 704 (1877). In 1995 this Court held that § 523(a)(2)(A) requires a showing of justifiable reliance on an alleged misrepresentation in order to warrant a loss of a discharge. *Field v. Mans*, 516 U.S. 59 (1995) Petitioner now seeks to establish the opposite rule—namely, that a debtor transferee can lose his discharge even where there is neither an actual misrepresentation by the debtor nor any reliance by the creditor.

The change in the law sought by Petitioner is based on a world view of the bankruptcy population as

inherently untrustworthy. Here they posit the paradigm of one who has allegedly "drained" his company of assets and then filed for bankruptcy. One amicus writes that the paradigm is illustrated by the Bernard Madoff Ponzi scheme. Law Prof. Amici Br. 29. Amici for Petitioner argue that the Fifth Circuit ruling "would reward the dishonest—especially the more ingeniously dishonest." Law Prof. Amici Br. 2. Others argue that debtors could exploit a loophole without reversal of the Fifth Circuit.

Yet, Petitioner's brief cites no empirical evidence to suggest that there is widespread misconduct by business debtors nor that the subset of the "ingeniously dishonest" contains more than a few Bernie Madoffs.[4] A more accurate view, however, of exactly who are the Chapter 7 debtors, and how they would be effected by the change in the law is found in empirical evidence. The number of Chapter 7 debtors who may be considered to be "self-employed" (and hence more accurately thought of as "business" debtors) is approximately 72,000 per year or roughly 14% of all Chapter 7 bankruptcy cases.[5] These Chapter 7 cases are typically the result of business stress and failure by entrepreneurial debtors, who stand to lose many years of future earnings by the rule urged here.[6]

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[4] Under § 727, certain dishonest debtors may be denied a discharge with respect to all debts. Bernie Madoff would have been denied a discharge under § 727(a)(2) on the basis that he transferred property with the intent to hinder, delay, or defraud his creditors.

[5] *Id.* at 112. The number of 72,000 is based on applying 14% to approximately 516,357 Chapter 7 cases filed in 2015. http://www.abi.org/newsroom/bankruptcy-statistics.

[6] "For the median self-employed debtor, it would take almost five years worth of income to retire the outstanding debts."

The change sought by the Petitioner will create unjustified and unnecessary leverage in favor of creditors against the self-employed debtor, for whom transfers between family and business occurs daily, through salaries and payment of normal expenses for living. Every constructive fraudulent conveyance will too readily become recast as "actual fraud" and the basis for an exception to discharge.[7] The targets of the change in the law will be those least able to defend against over-zealous creditors who will always see actual fraud. Thus, while the world may have but one Bernie Madoff, this Court has noted a wider universe of aggressive lenders who sometimes ensnare consumers through questionable lending practices.[8] It was for this reason that the Court spoke of "moderating" the burden on Chapter 7 debtors who seek a discharge. *Field v. Mans, supra* at 76.

The plain meaning of the Code does not justify the rule sought by Petitioner. The statutory phrase, "obtained by" limits the non-discharge rule to fraud at the inception of a transaction, that is, when the debt is first obtained. A discharge should be subject to challenge only where there is a causal nexus between

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Robert M. Lawless, *Striking Out on their Own: The Self Employed in Bankruptcy*, in BROKE: HOW DEBT BANKRUPTS THE MIDDLE CLASS, (Katherine Porter ed, 2012), 111.

[7] Constructively fraudulent conveyances can include certain transfers without regard to intent made while the debtor was insolvent (i.e., debts were greater than assets).

[8] This Court has noted that creditors sometimes engage in conduct which can encourage fraud in order to provide a later argument for a barrier to a discharge. *See Field v. Mans*, supra, noting the "practices of consumer finance companies which sometimes have encouraged such falsity by their borrowers for the very purpose of insulating their own claims of discharge." *Id.* at 77, n.13.

the alleged fraud and the breach of the original credit transaction. The notion of "actual fraud" embraces the traditional notion of "proximate cause." *See Archer v. Warner*, 538 U.S. 314 (2003)(Thomas, J., dissenting). And, in *Field v. Mans*, 516 U.S. at 66, this Court held that § 523(a)(2) applies when the debt "follows" the alleged fraud. The Seventh Circuit rule in *McClellan v. Cantrell*, 217 F.3d 890 (7th Cir. 2000), upon which Petitioner now relies, is to the contrary.

The Code currently provides ample protection for creditors who have been injured through fraudulent conveyances of assets. Few would dispute that § 523(a)(6) fully addresses the real concern of creditors in the position of Husky. *See McClellan v. Cantrell, supra.* at 896. ("The provision that most aptly describes the situation here is § 523(a)(6)")(Ripple, J. concurring). The rule advanced by the Petitioner will render § 523(a)(6) redundant, and thus there is yet another reason why there is no need for the expansion sought by Petitioner.

Reversal of the Fifth Circuit decision will reach into the corporate world as well, and will impair bedrock principles of corporate separateness. Reversal will make it more likely that aggressive creditors will seek to impose liability on owners of corporations and business entities even where the standard for piercing the corporate veil cannot be met. And, the rule advocated by the Petitioner is contrary to sound bankruptcy and economic policy. This Court has long underscored the critical importance of the discharge to the individual debtor's fresh start. *Williams v. United States Fidelity & Guaranty Co.*, 236 U.S. 549 (1915). This Court confirmed in *Neal v. Clark* that narrowly construing exceptions to discharge is "consonant with equity and consistent with the object and intention of

Congress in enacting a general law by which honest citizens may be relieved from the burden of hopeless insolvency. A different construction would be inconsistent with the liberal spirit which pervades the entire bankruptcy system." *Neal, supra.*, 95 U.S. at 709. The rule advanced by Petitioners is contrary to this spirit and policy. The decision in the Fifth Circuit should be affirmed.

ARGUMENT

I. The Legal Standard for Nondischargeability of a Debt Under § 523(a)(2)(A) Should Retain the Requirement of a Misrepresentation That Induced the Credit Transaction.

A. Reversal of the Fifth Circuit Decision Will Needlessly Harm Self-Employed, Honest Debtors.

The central issue in this case is not simply whether the "actual fraud" bar to discharge under § 523(a)(2)(A) of the Bankruptcy Code applies only where the debtor has made a false representation to obtain credit. Instead, the critical issue is whether debts will become nondischargeable under circumstances where Congress did not intend for the discharge to be lost and where bankruptcy policy favors protecting the discharge. The rule of law sought by Petitioner here will be unduly punitive, and will encourage creditors to pursue owners of small businesses who receive pre-bankruptcy transfers in the hopes of manufacturing a case for "actual fraud." *See Field v. Mans*, 516 U.S. at 77, n. 13.

In *Field v. Mans*, this Court held that denial of a discharge under § 523(a)(2)(A) requires a showing of

causation and justifiable reliance, in large measure because of the use of the phrase "obtained by . . . actual fraud." Petitioner seeks to have this Court hold that § 523(a)(2) prevents an individual debtor from obtaining a discharge even in the absence of (a) any misrepresentation to the creditor; (b) any showing of actual reliance; (c) any showing that fraud was used to obtain the initial credit and, (d) even in those cases where the alleged "fraud" occurs years after the initial credit transaction, such as where the debtor is only the transferee of a fraudulent conveyance.[9]

The outcome urged by Petitioner will expand the scope of nondischargeable debts significantly, and injure the typical Chapter 7 debtor who was self-employed, as well as transferees from larger companies. The first key point is that the transfers that may become labelled as "constructively fraudulent" under the Bankruptcy Code are the same transfers that are the daily stuff of a small to medium sized business. Small to mid-sized companies, owned by an individual or a family, are constantly transferring funds from the company to the individual; this is how such owners make a living. Cash flow is received, and then distributed to owners. The line between family and

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[9] Ritz himself is alleged to have directed the transfer to seven companies that he owned and controlled; he was not himself a direct transferee, but the owner of the transferee. However, the Petitioner has framed this case as whether "actual fraud refers to any intentional fraud, and includes a transferee's participation in a transfer scheme that he knows is intended to defraud creditors." Pet. Br. 14-15. And, as noted throughout, Petitioner argues case law dealing with transferee liability, including *Neal*. *Id*. at 15. Because he was not a transferee it is unclear how he could have "obtained" any property as a result of the fraud.

business is imperceptible at times.[10] When a business entity experiences financial difficulty, owners still distribute funds to themselves. Such distributions, typically including salaries, are honest and legitimate but in the eyes of a creditor seeking to challenge a discharge, the allegation that the transferee knew the entity was insolvent and thus was "draining" the company by making payments, is easy to make, especially in hindsight, costly to defend, and will tilt the litigation strategy in favor of creditors seeking to extract settlements from smaller debtors. Litigation will increase and the result may be unjust and unfair.

The second key point is that while the paradigm of the "Bernie Madoff" case is rare, the number of business bankruptcies involving Chapter 7 debtors is large. "Most business bankruptcy cases filed in the United States involve small and middle-market enterprises. These businesses include family owned businesses, entrepreneurial ventures and startup companies."[11] Small and middle market companies are prone to failure and "can be among the hardest hit in economic downturns." *Id.* Those who enter bankruptcy owning their own business, (including the "self-employed"), are in the most vulnerable position. ("If the 1.5 million bankruptcy cases filed each year come

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[10] As one scholar framed it, "For most every self-employed person in bankruptcy, it makes no sense to talk of a business with a separate existence apart from its owner. The owner's financial life is the business' financial life and vice versa . . . Ninety-six percent [of business debtors] report some use of personal financial resources to support the business . . ." Robert M. Lawless, *Striking Out on their Own: The Self-Employed in Bankruptcy*, BROKE: HOW DEBT BANKRUPTS THE MIDDLE CLASS, *supra* at 109.

[11] American Bankruptcy Institute, Commission to Study the Reform of Chapter 11, 2012-2014 Final Report and Recommendations (2014), 276 ("ABI Report").

from people at the bottom of the financial heap, the self-employed are the bottom of the bottom.")[12]

Third, the failure of the mid-sized business entity often leads directly to the individual Chapter 7 bankruptcy filing. The business entity failure engulfs the business owners—those who become Chapter 7 debtors. "The changes in the composition of small businesses in bankruptcy may also suggest an ever-tighter link between the failure of a small business and the failure of its owner."[13] One commentator writes that, "one in seven individuals in the bankruptcy system is a struggling entrepreneur."[14] These self-employed owners who need to consider bankruptcy protection will be greatly disadvantaged by a change in existing law.

The determination that a debt is nondischargeable for the business Chapter 7 debtor has severe consequences. A detailed study of the relationship between small businesses entrepreneurs and bankruptcy shows that, unlike their large corporate counterparts, these debtors' personal assets are exposed to creditors; "[i]t is only the debtor's personal assets, such as the house, the car and the checking account, that are the target of creditor actions."[15]

Fourth, the number of cases that may be affected by the change sought by Petitioner is large. Research discloses that about one in seven Chapter 7 debtors are "self-employed" or business debtors. In 2015 there

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[12] Robert Lawless, *Striking Out on their Own*, *supra* at 109.

[13] Robert Lawless and Elizabeth Warren, *supra* at 791.

[14] *Id.* at 786.

[15] *Id.* at 792. This would pertain unless the specific asset was exempt under applicable law. *See* § 522(b).

were 516,357 Chapter 7 cases, and thus approximately 72,000 Chapter 7 debtors could be affected by the change sought by the Petitioner.[16]

Fifth, Petitioner offers neither documented nor empirical evidence of wide spread dishonesty by the typical Chapter 7 business debtor. The empirical evidence does document the financial distress at the very "bottom of the bottom." The classic example that deserves focus here is not Mr. Ritz. Instead, the more typical situation is where a debt is obtained honestly by a small or medium size company that is family or farm owned.

Honest transfers may be easily alleged to be improper. This Court itself noted that sometimes creditors themselves engineer this result. *Field v. Mans*, *supra*. at 77, n.13. The badges of fraud make the transition from insider transfer to "actual fraud" easy to allege. If the Petitioner succeeds in this case, creditors are almost certain to use the enlarged definition of § 523(a)(2) to enslave these business owners with debt that they cannot discharge.[17] Creditors will be even more likely to argue that the knowing receipt of a transfer of funds years after the credit was obtained is sufficient "actual fraud" to deny individuals a discharge.

This case illustrates how a lack of documented financial harm to a creditor can be presented in a

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[16] *Id*. at 793.

[17] "If the median self-employed person devoted all income to debt repayment—forgoing food, clothing, and all other necessities of life- it would still take that five years of work before all outstanding debts were repaid. When they arrive in bankruptcy, the self-employed are in a deep financial hole." Lawless, *supra* at 111.

prejudicial light, even if lacking in substance. In this case, the Petitioner's brief repeatedly identifies Ritz as one who "drained" the estate of his company, and thus is unworthy of receiving a discharge. Indeed, the "Question Presented" asks this Court to address a "fraudulent transfer scheme that was actually intended to cheat a creditor." Pet Br. i.[18] Yet, the facts presented do not show that the "scheme" diminished the assets in the Ritz' bankruptcy estate. According to Petitioner, Ritz transferred "over a million dollars" from Chrysalis to "seven other entities that he [Ritz] owned and controlled." Pet. Br. 6. Ritz filed for bankruptcy sometime thereafter. *Id.* At the time of his filing, the value he transferred to his owned entities (the same $1.0 million) would be part of his personal bankruptcy estate as the "equity value" in these entities. Accordingly, there should have been no loss of value to Ritz' creditors. Petitioner fails to explain how these internal transfers injured creditors since the value remained within Ritz' entities, all of which are part of a Chapter 7 estate.

Perhaps for this reason, or others, all three courts below found that "Husky failed to meet its burden to show that Ritz intended to willfully and maliciously injure Husky, as required by § 523(a)(6)." Petitioner Br. 7, n.3. Further, the Court of Appeals affirmed the bankruptcy court's finding that there was "scant evidence in the record indicating either that Ritz made the[] transfer with the intent to harm Husky, or that harm to Husky was substantially certain due to Ritz'

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[18] Significantly, Husky was not found to be a creditor of Ritz, at least not for the purchases made by Chrysalis. The claim for non-payment was a liability of Chrysalis. The bankruptcy court found no basis to pierce the corporate veil and make that claim a debt owed by Ritz. *In re Ritz*, 787 F.2d at 315.

action." *Husky International v. Ritz*, 787 F.3d 312, 321 (5th Cir. 2015). Thus, the "Question Presented" cannot truly be answered on this record, since it seems doubtful there was an "actual intent to cheat" as suggested by Petitioner. Pet. Br. at i. For these reasons alone, the Fifth Circuit's decision should be affirmed.

This, then, is not a case about wide spread fraud, ingenious debtors or Bernie Madoff. This case seeks a change in the law that will target the typical Chapter 7 business owner. The rule will be harmful, severe, and as noted below, unnecessary. The rule advanced by the Petitioner will have the direct effect of targeting for discharge litigation the owners of small and medium sized businesses, and will do little or nothing to address purported issues with "dishonest debtors."

B. Reversal of the Fifth Circuit Decision Will Harm Executives and Employees of All Businesses; Affect Chapter 11 Cases, and Impair the Important Goal of Corporate Separateness.

Beyond causing needless loss to the self-employed Chapter 7 debtor, it is critical to note that a similar detrimental outcome will occur in Chapter 11 cases, especially where the executives or owners of a company, private or public, or forced to file an individual bankruptcy case when the entity itself fails. An individual who files for protection under Chapter 11, 12 or 13, and seeks a discharge, is subject to the limits of § 523(a)(2)(A). *See* § 523(a) referring to a discharge under § 1141, § 1228(b), and § 1328(b).

The threatened loss of a discharge in this context imperils the key notion of corporate separateness; "[L]imited liability is the rule, not the exception."

Anderson v. Abbott, 321 U.S. 349, 362 (1944). Entrepreneurs invest in entities, including public companies and limited liability companies, based in part on the legal assurance that they will be insulated from liability for the claims of the company. Based on "that assumption [of limited liability] large undertakings are rested, vast enterprises are launched, and huge sums of capital attracted." *Id.*

This Court has spoken to the issue of separateness. While fraud may sometimes permit piercing the corporate veil, the general rule is that the owners are not liable for the debts of the entity, just as the parent corporation is not liable for the debts of its subsidiaries:

> It is a general principle of corporate law deeply "ingrained in our economic and legal systems" that a parent corporation (so-called because of control through ownership of another corporation's stock) is not liable for the acts of its subsidiaries. Douglas & Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 YALE L.J. 193 (1929); 1 W. Fletcher, Cyclopedia of Law of Private Corporations § 33, p. 568 (rev. ed. 1990) ("Neither does the mere fact that there exists a parent-subsidiary relationship between two corporations make the one liable for the torts of its affiliate").

United States v. Bestfoods, 524 U.S. 51, 61 (1998).

The Fifth Circuit decision is in accord with this notion of separateness, because it provides appropriate assurance that creditors are not given unfair leverage to penetrate the wall of separateness and hold owners, executives, officers and directors liable

for the debts of their entity under the guise of a "fraudulent conveyance," especially where no reliance has been shown.

The requirement for an actual representation under § 523(a)(2)(A) maintains the barriers between individuals and corporate entities, and aligns the bankruptcy outcome more with the common law, which does not impose liability in the absence of an affirmative showing that would permit piercing the corporate veil. Modern corporate law theory requires a high threshold showing to pierce the corporate entity and requires substantive showings well beyond mere receipt of a transfer during a period of distress. *See generally*, 191 Fletcher Cyc. Corp. § 41.30. This is particularly true in this kind of case, given that the bankruptcy court found that Husky had *not* made the requisite showing to pierce the corporate veil under Texas law.[19] Reversal of the Fifth Circuit decision would open a Pandora's box of consequences undercutting the limited liability principles that are the foundation of corporate law.

Corporate separateness could be weakened by a rule that imposes liability on bankruptcy debtors who received any kind of distribution, including ordinary compensation, while serving as a senior executive of a large company, or acting as a self-employed owner of a limited liability company. Many of these companies are thinly capitalized. They may hover in the zone of insolvency for years and still be viable, paying regular salaries to employees and officers. An economic shock may then force company and owner/executive into bankruptcy. Any insider transfers, including salaries, would open up the individual to a claim of a fraudulent

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[19] *In re Ritz*, *supra*, 787 F.2d at 315.

conveyance and a loss of a discharge in the individual case. This is nothing more than a back door effort to erode the theory of corporate separateness, which has long been a bedrock of American corporate law.

II. The Fifth Circuit Correctly Applied the Plain Meaning of Section 523(a)(2)(A).

A. The Fifth Circuit's Opinion Properly Applies the Holding in *Field* that the Debt Must Be "Obtained by" Fraud and thus the Credit Must "Follow" the Alleged Fraud.

Section 532(a)(2)(A) is properly read to mean, plainly, that in order to deny a debtor a discharge, there must be a showing that there was an actual misrepresentation made to the creditor, at the inception of the credit transaction, that is, when the credit or money was "obtained" and that there was justifiable reliance. The section bars from discharge "any debt . . . for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by . . . false pretenses, a false representation, or actual fraud." 11 U.S.C. § 523(a)(2)(A).

The key phrase is "obtained by." In *Field v. Mans*, 516 U.S. 59 (1995), this Court held that § 523(a)(2)(A) requires a showing of causation and justifiable reliance because of the use of the phrase "obtained by . . . actual fraud." ("No one, of course, doubts that some degree of reliance is required to satisfy the element of causation inherent in the phrase 'obtained by" . . .") *Id.* at 66.

More to the point, in *Field* this Court stated explicitly that § 523(a)(2) "applies expressly . . . when the debt *follows* a transfer of value or extension of

credit induced by falsity or fraud." *Id.* at 66 (emphasis added). Thus, the fraud must occur first, and *then* the extension of credit, (and hence the fraud is the cause of the debt) and not as here, the extension of credit first, and years later, some alleged misconduct.

Justice Ginsburg's concurring opinion in *Field* strongly intimated that if the fraud did not occur at the inception of the loan transaction, there was no liability under § 523(a)(2). At oral argument, Justice Ginsburg asked counsel what would happen if the debtor had transferred the property "without saying one word to the creditor." *Id.* at 79. In that case there would be neither a representation nor reliance at the time credit was extended, and hence the loan would not be "obtained by" fraud. Counsel answered that "I would agree with you, it would be dischargeable." *Id.*[20]

The notion that the debt must be obtained by fraud at the inception of the credit transaction in order to justify a challenge to discharge finds direct support in the opinions of Justices Thomas and Stevens, dissenting, in *Archer v. Warner*, 538 U.S. 314 (2003). There they stated that there must be a causal nexus between

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[20] Justice Ginsburg stated that a causation issue was "still open for determination on remand . . . Was the debt in question, as the statute expressly requires, obtained by the alleged fraud." *Id.* at 78. Justice Ginsburg did not express an opinion on the appropriate resolution of the unsettled causation ("obtained by") issue, but the exchange at oral argument suggests it was a determining issue. She noted that it had been raised below, and the same is true here. Ritz argued that the loan was not obtained by fraud, but the Fifth Circuit stated it did not need to reach this alternative argument. *Husky International Electronics, Inc. v. Ritz (In re Ritz)*, 787 F.3d 312, 316, n.4 (5th Cir. 2015).

the fraud and the debt, which arises from the requirement that the debt be "obtained" by fraud and gives meaning to the inherent limit in all definitions of fraud of "proximate cause."

> In interpreting this provision, the Court has recognized that, in order for a creditor to establish that a debt is not dischargeable, he must demonstrate that there is a causal nexus between the fraud and the debt. See *Cohen v. de la Cruz*, 523 U.S. 213, 218, 118 S.Ct. 1212, 140 L.Ed.2d 341 (1998) (describing § 523(a)(2)(A) as barring discharge of debts "'resulting from'" or "'traceable to'" fraud (quoting *Field v. Mans*, 516 U.S. 59, 61, 64, 116 S.Ct. 437, 133 L.Ed.2d 351 (1995))). Indeed, petitioners conceded at oral argument that the "obtained by" language of § 523(a)(2) requires a creditor to prove that a debtor's fraud is the proximate cause of the debt.

Archer v. Warner, 538 U.S. 314, 325-26 (2003).

Justices Thomas and Stevens correctly viewed the language of § 523(a)(2)(A) as containing the traditional notion of "proximate cause" in understanding the meaning of fraud. Thus, certain intervening causes "are sufficient to sever the causal nexus and cut off all liability." *Id.* at 326. The conduct of a transferee, years after a credit transaction, may have no relationship to the failure of an entity to repay a loan.

Decisions from the lower courts also support the view that a debt does not become nondischargeable under § 523(a)(2) through a post-transaction fraud. For example, in *In re Blake*, No. 13-20982 (ASD), 2015 WL 5601346, *3 (Bankr. D. Conn. Mar. 9, 2015) the

court held that nondischargeability is only permitted where the fraud occurred "at the time of, and has been the methodology by which the money, property or services were obtained." Further, it elaborated that fraud must occur at the "inception:"

> That is to say, the "funds themselves must have been obtained by fraud in the inception." . . . Misrepresentations that are made subsequent to the creation of the debt "have no effect upon the dischargeability of a debt, since the false representation could not have been the creditor's reason for the extension of credit." (citations omitted).

Id.

This case presents an opportunity for this Court to clarify the ruling in *Field v. Mans* on the full import of the word "obtained" and its relationship to the notion of causation. Justice Ginsburg noted that the issue of the full import of "obtained" was not resolved in *Field*. ("I express no opinion on the appropriate resolution of the unsettled causation ("obtained by") issue.") 516 U.S. at 79. While both the majority and Justice Ginsburg strongly intimated that "obtained by" was a significant limit, neither signaled a full resolution. This case now presents that opportunity.

B. Section 523(a)(2) Should Not be Read As Encompassing All Common Law Fraud.

Petitioner argues that § 523(a)(2) embraces the entire universe of common law fraud. This misses the structural and textual limits that are contained within this section. First, the interpretation of "actual fraud" in § 523(a)(2) must be based on the rule of construction that the surrounding text and provisions provide key

illumination into the meaning. ("It is a familiar rule in the interpretation of written instruments and statutes that 'a passage will be best interpreted by reference to that which precedes and follows it.") *Neal v. Clark*, *supra* at 709.[21] The term "actual fraud" in this section relates to what precedes it, and does not open up the entire universe of fraud. That is why *Field v. Mans* requires an actual representation to a creditor, and did not intimate that the phrase "actual fraud" was an independent and unrelated basis for loss of discharge. Some misrepresentations are *not* fraud, but are negligent, and thus the phrase "actual fraud" serves to limit the kinds of misrepresentations that do bar a discharge, but does not necessarily signal that § 523(a)(2) embraces the entirety of the common law meaning of fraud.

Second, related to this, the insertion of an "or" between misrepresentation and "actual fraud" does not suggest that actual fraud is entirely independent of what precedes it. "Actual fraud" limits misrepresentation, but does not create a wholly new category. "Or" is not necessarily the signal that this is a separate category, unrelated to the language that precedes it.[22] The Fifth Circuit noted that COLLIER ON BANKRUPTCY supported the notion that this phrase did not suggest

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[21] Context is also key to statutory interpretation. "The plainness or ambiguity of statutory language is determined by reference to the language itself, the specific context in which that language is used, and the broader context of the statute as a whole." *Robinson v. Shell Oil Co.*, 519 U.S. 337, 341 (1997).

[22] *See* discussion in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065, 2068 (2012) where Justice Scalia said that such an insistence on the meaning of "or" was being hyper-literal. "The debtors' reading of § 1129(b)(2)(A), under which clause (iii) permits precisely what clause (ii) proscribes, is hyperliteral and contrary to common sense."

a separate category of non-dischargeability.[23] This Court stated as much in *Field* where it said that some misrepresentations may be innocent and not evidence fraud. 516 U.S. at 68, n.7. Thus the addition of "actual fraud" limited "misrepresentation." It did not expand it into unrelated forms of fraud or strip out proximate cause and causality.

Third, even if the term "actual fraud" embraces the common law concept of the tort of fraud, that concept is itself tempered and limited by notions of proximate cause. "The Court has explained that, '[a]t bottom, the notion of proximate cause reflects 'ideas of what justice demands, or what is administratively possible and convenient.'" And equally key here, "What we do mean by the word 'proximate' is, that because of convenience of public policy, of a rough sense of justice, the law arbitrarily declines to trace a series of events beyond a certain point.'" *Archer v. Warner*, *supra*, at 538 U.S. at 326, citing *Palsgraf v. Long Island R.R. Co.*, 248 N.Y. 339, 352, 162 N.E. 99, 103 (1928) (Stevens, J. and Thomas J., dissenting). Here, there are limitless intervening events which caused Chrysalis not to be able to repay Husky; the transfer of funds to another entity, years later, does not satisfy this common law notion of proximate cause.

The Petitioner's argument that there is no need for an actual representation eliminates the requirement

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[23] The Fifth Circuit also acknowledged this: "Here, although "actual fraud" was added to the statute in 1978, some have suggested that Congress did not intend to create a separate basis for dischargeability – but rather intended only to codify 'the limited scope of the fraud exception to mean actual or positive fraud rather than fraud implied by law," citing to Alan N. Resnick & Henry J. Sommer, Collier on Bankruptcy, ¶ 523.08[01][e] (16th ed. 2014). 787 F.3d at 320.

that the debt be one "obtained" by fraud, and in so doing, eliminates causation and proximate cause. The requirement that the debt be "obtained" by fraud, is closely tied to the well-developed law in this area that requires a representation to a creditor and a causal connection and justifiable reliance. The interpretation urged by Petitioner would embrace all conduct by all persons at any time, regardless of how the loan was obtained, and regardless of any reliance. This would of course effect a sea change in the law, a change unwarranted by the absence of any congressional intent to do so.

C. The Seventh Circuit Decision in McClellan v. Cantrell Incorrectly Ignored the Requirement for a Misrepresentation.

Petitioner urges this Court to follow the contrary rule announced by Judge Posner writing for the Seventh Circuit in *McClellan v. Cantrell*, 217 F.3d 890 (7th Cir. 2000). The Seventh Circuit held that § 523(a)(2) "is not limited to misrepresentations and misleading omissions" but includes "deliberate fraudulent-transfer schemes, 217 F.3d at 893." (Pet. Br. 13). The First Circuit, argues Petitioner, follows *McClellan* holding that actual fraud "includes knowing receipt of a fraudulent conveyance" designed to hinder, delay or defraud creditors. 791 F.3d 214, 225 (1st Cir. 2015)." Pet Br. 13, citing *In re Lawson*.

Judge Posner stated that there was no authority on point and that *Field* "has nothing to do with this case." *Id.* at 892. In order to get around the absence of any fraud when the debt was incurred, he constructed a "second debt" theory. *Id.* at 895. This second debt is not the credit transaction, but the obligation that

arises as a matter of law when one is liable under a theory of a fraudulent conveyance. *Id.*

The notion that the fraudulent conveyance gives rise to a separate debt or claim was rejected by the Ninth Circuit in *In re Saylor*, 108 F.3d 219, 221 (9th Cir. 1997). "Quarre's claim that he possesses a property interest in the fraudulent transfer remedies provided by state law does not fit within the definitions of either "debt" or "property" for purposes of section 523(a)(6), and runs counter to the long-standing principle that exceptions to dischargeability are to be narrowly construed."[24]

The problem with the *McClellan* analysis is that it simply reads too much out of the Code. Instead of adhering to the language of § 523(a)(2)(A) *McClellan* creates a broad barrier to discharge any time any debtor receives any property based on any kind of common law fraud. The context of § 523(a)(2) however evidences a narrower Congressional intent. Had this view of "actual fraud" been intended, then none of the other text in § 523(a)(2) would have been necessary, thus rendering most of the section superfluous.

Petitioner relies on *Neal* and argues that "*Neal* made clear that receiving a fraudulent transfer, with intent to commit a fraud or to help the transferor in doing so, makes the transferee liable for actual fraud. That is so even through the transferee's fraud involves no misrepresentation whatsoever." Pet. Br. 15.

The Court in *Neal* was not asked to address, and did not address, the question of whether transferee liability can arise where there is a showing of actual

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[24] Although this case arose in the context of a debtor as transferor, the logic is the same when dealing with a transferee.

fraud, nor the level of actual fraud, nor the legal standard to show such fraud. Even Judge Posner noted that no appellate decision had yet addressed the type of fraud that comes within the exception for "actual fraud" in the discharge context. *McClellan*, *supra* at 892.

Neal is an important case, but not for the reasons cited by Petitioner. What is important about *Neal* was this Court's insistence that in the absence of actual fraud, there is no rationale for considering a loss of the discharge. Further, the kind of fraud of concern to the Court was "associated directly with debts created by embezzlement." *Id.* at 709. The fraud referred to in that section means positive fraud, or fraud in fact, involving moral turpitude or intentional wrong, as does embezzlement . . ." *Id.* The standard of fraud was high, and your amicus urges this Court not to suggest any erosion in this high standard.

D. Section 523(a)(6) Amply Protects Creditors from the Kind of Harm Envisioned in this Case. Reversal would render § 523(a)(6) superfluous.

Circuit Judge Ripple in *McClellan*, concurring, correctly stated that § 523(a)(6) was the "proper avenue of relief in favor of an awkward and ill-fitting one." *Id.* at 896. We submit that Judge Ripple's concurrence correctly identifies the true remedy for those in the position of Husky, and that § 523(a)(2) simply does not pertain.

Other courts have correctly noted that § 523(a)(6) provides adequate protection for creditors who are injured by torts and seek to challenge a debtor's discharge.

> We thus note that in the exceptions to discharge articulated in § 523, Congress provided protection for creditors injured by the torts of bankrupt debtors in subsection (a)(6), which excepts from discharge a debt incurred as a result of the debtor's "willful and malicious injury" to the creditor or her property. It would be unnecessary for subsection (a)(2)(A) also to provide relief for judgment creditors injured in tort.

In re Gonsalves, 519 B.R. 466, 473 (Bankr. D. Md. 2014).

Section 523(a)(6) embraces a more equitable standard for loss of discharge, because it requires a showing of a "willful and malicious injury by the debtor to another or to the property of another entity." This Court held in *Kawaauhau v. Geiger*, 523 U.S. 57 (1998) that this requires a showing that the actor intended "the consequences of an act, not simply the act itself." *Id.* at 61-62. One court has held that this means a discharge can only be lost if there is an "objective substantial certainty of harm or a subjective motive to cause harm." *Miller v. J.D. Abrams, Inc. (In re Miller)*, 156 F.3d 598, 606 (5th Cir. 2014).

Conversely, under the rule sought by the Petitioner, a nondischargeable debt could be predicated on a presumption of fraud alone (e.g., a "badge of fraud"), without any evidence of willful or malicious conduct. These badges of fraud may be less rigorous than the standard of willful or malicious and may involve nothing more than a transfer to an insider.[25] This is

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[25] Creditors may seek to bar a discharge based on a presumption of fraud, that is, the through the use of badges of fraud. A "badge of fraud" is a presumption that may provide the elements

particularly pernicious for the self-employed Chapter 7 debtor, since the debtor's source of livelihood frequently depends on routine transfers from the entity to the "insider."

Alternatively, some might argue that § 523(a)(6)'s requirement of willful and malicious requires the same showing of intent as "actual fraud." It bears noting that the courts below found that this case did not satisfy the standard of "willful and malicious." Petitioner Br. 7, n.3. And there was, as noted, "scant" evidence of an actual intent to harm.[26] If § 523(a)(6)'s requirement for "willful and malicious" is meant to be the same standard as "actual fraud" under § 523(a)(2), then the Fifth Circuit's decision should be affirmed on the basis that there was no showing of actual fraud, and indeed, no basis for this appeal.

E. Sound Bankruptcy Policy Dictates Against Further Expansion of Debts that are Nondischargeable.

It is a long standing rule of construction that exceptions to dischargeability are narrowly construed. *Fezler v. Davis (In re Davis)*, 194 F.3d 570, 573 (5th Cir. 1999). This rule of construction is reflective of a broader policy that correctly sees the economic and

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of fraud. Transfers to an insider along with some other evidence of intent to hinder or delay may be sufficient. *See* Edward S. Weisfelner, ADVANCED FRAUDULENT TRANSFERS, 59 (ABI, 2014). If so, creditors might then argue that "actual fraud" under § 523(a)(2)(A) could be established by a presumption, whereas the current version of the code requires willful and malicious tort injury under § 523(a)(6). There is thus a potential for conflicting standards of proof.

[26] *Husky International Electronics, Inc. v. Ritz*, 787 F.3d 312, 321 (5th Cir. 2015).

social function of discharge as serving two goals; protecting the debtor and allowing him to become a more productive economic actor in our society, and legal symmetry that treats the individual debtor with similar rights and outcomes as the corporate debtor.

Under the rule sought by Petitioner, individual debtors may be obligated to spend much of their economic life paying for a loan transaction in which they had no involvement, and where their liability may have been grounded only on a presumption of fraud. The insistence on having an "actual representation" protects against this outcome, and is the correct result here.

CONCLUSION

For the foregoing reasons, amicus requests that the decision of the Fifth Circuit be affirmed.

Respectfully submitted,

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